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The Treaty On Stability, Coordination And Governance In The Economic And Monetary Union

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THE TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION[1]

On 2 March 2012 Malta signed the European Union (EU) Treaty on Stability, Coordination and Governance (TSCG). The Maltese Parliament ratified this Treaty in June 2013, which became effective in Malta on 1 July. All provisions of the TSCG apply in full in view of Malta's adoption of the euro as its currency.

This report looks at the main provisions of the Treaty that focus on enhancing fiscal discipline in the European Union, which are known as the Fiscal Compact. It briefly examines the relationship of the TSCG to other EU Treaties, before outlining some of the key changes and their implications for fiscal policy in Malta.

Overview of EU fiscal legislation

The basis for fiscal surveillance in the European Union is found in the Treaty for the Functioning of the European Union (TFEU), which requires EU Member States to treat their economic policies as a matter of common interest and to coordinate them within the EU Council.[2] The TFEU also obliges EU Member States to avoid excessive government deficits and debt. A country is generally deemed to be in excessive deficit if the general government deficit and debt exceed certain thresholds, which are set at 3% and 60% of GDP, respectively.

The provisions of the TFEU are further elaborated in a set of secondary legislation known as the Stability and Growth Pact (henceforth, the Pact), which was approved in 1997 and reformed in 2005 and 2011. The latter reform is part of a broader reform of EU governance that is known as the "six pack". The Pact sets out a sequential list of actions expected of Member States and EU institutions. Member States are obliged to prepare Stability Programmes. The Member States and the EU institutions are also bound to monitor compliance with the excessive deficit prohibition and ensure that, once the EU Council decides that an excess fiscal deficit exists, corrective measures are adopted and implemented in a timely and lasting manner.

In addition, the Pact requires a Member State to make adequate progress towards the country specific targets for the structural balance known as Medium-Term Objective (MTO). The structural balance is the headline government balance, adjusted to exclude the impact of both temporary fiscal measures and cyclical effects. The Pact also allows the use of financial sanctions to ensure the timely correction of deviations from the MTO. Assessments of whether excesses are being corrected in a satisfactory way rely heavily on developments in the country's structural balance.

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[2] The TFEU supersedes the Treaty establishing the European Community. It became effective with the entry into force of the Treaty of Lisbon in 2009.

The Pact contains "escape clauses" that are meant to reduce the likelihood of a country being penalised for exceptional developments that have a major adverse impact on its fiscal position, but which are beyond the government's control, including severe economic downturns. It also allows for certain reforms which may have an adverse short-term impact on the government's fiscal position, but which would improve it in the longer term, such as pension reforms. Overall, the reliance on the structural balance and the escape clauses defined in the Pact ensure that a country is not penalised automatically if the headline deficit and debt ratios exceed the respective thresholds. Deviations from the MTO should in principle be allowed only if they arise from the exceptional circumstances mentioned in the escape clauses.[3]

Key elements of the TSCG

The TSCG is an inter-governmental treaty agreed between 25 EU Member States that builds on the TFEU and the Pact. It does not replace them. Indeed, Article 2 states that the TSCG only applies to the extent that it is compatible with the EU Treaties.[4] The TSCG also refers explicitly to certain rules already defined in the Pact as reformed in 2011. This is the case, for example, with regard to the definitions of the structural balance and of significant deviation from the MTO, as well as the "operationalization" of the debt benchmark, which was clarified for the first time in the 2011 reform. Progress towards the MTO is also based on changes in the structural balance, with the TSCG largely replicating the escape clauses in the Pact. Indeed, it has been argued that the more significant changes to the framework governing fiscal surveillance in the European Union came with the 2011 reform rather than the TSCG itself.

The TSCG, however, does introduce a number of changes in relation to fiscal surveillance. These are meant to enhance fiscal discipline in the European Union, thereby strengthening the economic pillar of Economic and Monetary Union (EMU).

A key achievement of the TSCG is that it elevates the rules governing fiscal surveillance, which until recently were defined in detail in secondary legislation (the Pact) to primary law. This is the case, for example, with the debt benchmark specified in the Pact. This specifies that a country with a debt-to-GDP ratio exceeding 60% must reduce the gap between its debt ratio and the 60% reference value by 1/20th annually over a number of years.[5]

The TSCG also extends the principle of reverse qualified majority voting, which was introduced with regard to the application of financial sanctions in the 2011 reform of the Pact, to a larger number of steps that form the Excessive Deficit Procedure (EDP). The

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[3] A fuller account of how the EU fiscal surveillance framework has evolved is given in "Building a strengthened fiscal framework in the European Union: A guide to the Stability and Growth Pact", *Occasional Paper* No. 150, European Commission. A more technical account is given in "Vade mecum on the Stability and Growth Pact", *Occasional Paper* No. 151. See also "A Fiscal Compact for a stronger Economic and Monetary Union", *Monthly Bulletin*, ECB, May 2012.

[4] Article 2 of the TSCG states that: "The Treaty shall apply insofar as it is compatible with the Treaties on which the European Union is founded and with European law. It shall not encroach upon the competence of the Union to act in the area of economic union".

[5] An explanation of how the debt benchmark is applied is provided in "Vade mecum on the Stability and Growth Pact", *Occasional Paper* No. 151, European Commission, pp. 51-54.

application of reverse qualified majority voting means that EU Council Decisions apply by default unless a qualified majority of eligible voting countries reject them. The Treaty obliges the Member States to support the proposals and recommendations of the European Commission in the context of the EDP, unless a qualified majority of Member States are opposed to them.

This contrasts with the TFEU and the Pact, where EU Council Decisions normally only apply if a qualified majority supports them. These innovations are meant to increase the likelihood that any required corrective action and, in the event of non-compliance, financial sanctions, are effected earlier on, rather than in the later stages of the EDP when the fiscal position is likely to be under greater stress.

The TSCG also foresees a greater role for independent monitoring institutions at national level and for national parliaments. In particular, it foresees conferences between representatives of European Parliament and national parliaments to discuss budgetary policies and other issues covered by the Treaty. Together with the greater role for independent national monitoring institutions, this should increase national ownership of the budgetary process and, hence, ensure compliance with EU fiscal rules.

Although the concept of MTO, along with deviations from it and exceptional clauses, are by and large unchanged from those in the Pact, the TSCG has new elements that affect the pace of progress towards the MTO. More specifically, progress towards the MTO has to be "rapid". Furthermore, deviations from the MTO or the adjustment path towards it must be corrected automatically, while the automatic corrective mechanism must be in line with the common principles published by the European Commission in 2012. These principles cover the nature, size and time frame for correction, and the role and independence of national monitoring institutions.[6]

The Treaty foresees that the corrective mechanism should aim at correcting not only recent deviations, but the cumulated impact of deviations from the MTO on government debt dynamics. The Commission's principles foresee that national rules implementing the TSCG should, as a minimum, respect the provisions of EU legislation, including the TSCG. They also foresee that an EU decision establishing the presence of a significant deviation from the MTO would be sufficient to trigger the automatic corrective measures. The size and timeline for the correction should in turn be based on pre-determined criteria. There is also the expectation that larger deviations from the MTO should lead to larger corrections, and that the correction mechanism should aim at restoring the structural balance at or above the MTO within the planned deadline and keep it there. Moreover, a plan that would be binding throughout the period of correction would need to be presented at the outset. The automaticity embedded in the TSCG and the Commission principles should limit the delays involved in the application of the corrective arm of the EDP.

[6] See Communication from the European Commission, "Common principles on national fiscal correction mechanisms", *COM* (2012) 342 final.

This automaticity in the correction of excesses and in the application of forward-looking constraints was not inherent in the Pact.

The Commission's principles also acknowledge the role of national independent monitoring bodies in charge of examining whether circumstances warrant the activation of corrective mechanisms and whether the correction is in line with the minimum requirements. Such bodies, whose assessments would be public, would also evaluate the case for and against the application of escape clauses. According to the Commission's principles, these bodies are meant to support the credibility and transparency of the corrective mechanism. The Member State would need to comply with these bodies' assessments or explain publicly why it does not.

Implications for fiscal policy in Malta

Like other signatories to the TSCG, Malta has a legal obligation to implement these rules, including the setting up of automatic corrective mechanisms and the establishment of independent national monitoring institutions entrusted with assessing fiscal policy under national law. Such implementation must rely on "provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes". Malta's deadline for transposition into national law is 1 July 2014.[7]

Under the TSCG Malta is committed to general government budgets that are balanced or in surplus. For countries that have a debt ratio exceeding 60%, as is the case of Malta, this commitment is considered to be fulfilled if the structural balance shows a deficit no larger than 0.5% of GDP in the medium term. If a country reduces its general government debt ratio to well below 60%, and if risks to long-term sustainability of public finances are assessed to be low, then a structural deficit limit of 1% of GDP applies.

As stated in the latest Update of the Stability Programme, Malta's MTO is a balanced budget. Effectively, therefore, Malta is already committed to a medium-term position that complies with the TSCG's minimum requirement for countries with a debt ratio exceeding 60%.

Furthermore, as the EU Council has re-opened the EDP for Malta, the Government is expected to submit a budgetary and economic partnership programme detailing structural reforms that ensures a lasting correction of the excessive deficit, and annual budgetary plans consistent with such a programme.[8]

The TSCG specifies that the Council may also decide that an excessive deficit exists in situations in which the government deficit is below the 3% limit but the debt criterion is

7 If any signatory does not meet its deadline for the transposition of the Treaty, a case would be brought before the European Court of Justice, which may impose a deadline for transposition, and, in case of continued non-compliance, financial sanctions of up to 0.1% of GDP.

8 See press release entitled "Council reopens excessive deficit procedure for Malta", *Council of the European Union*, 21 June 2013.

not met. This is relevant to Malta, as the general government debt ratio exceeds the 60% threshold.

All euro area signatories are also required to inform the EU Council and the European Commission in advance of the public debt issuance plans and of other major economic reforms.

Conclusion

A cautious and prudent fiscal process is essential for the correction of economic imbalances and improvements in competitiveness. Towards that end, the provisions of the TSCG constrain the fiscal authorities' room for manoeuvre. However, it should also be noted that fiscal authorities retain considerable discretion in terms of specific tax and expenditure measures in the budgetary process.

Depending on how ambitious the national implementation provisions will be and on their proper enforcement, the TSCG brings forward the consolidation effort that is needed for a sounder fiscal position. The application of the TSCG and related principles would also limit the scope for quick-fix solutions that may improve the headline ratios in the short run without achieving a durable improvement in structural terms.

The new constraints do not arise so much from changes in concepts underlying fiscal surveillance or from the application of a more ambitious MTO. Rather, they follow, first, from the more explicit acknowledgement that non-compliance with the debt criterion would be subject to the same disciplinary steps which are invoked for breaches of the deficit criterion and the need to correct the effect of past excesses on the debt.

They also stem from the creation of independent national bodies, whose powers will be grounded in EU and national legislation of the highest order, to provide an additional layer of scrutiny of public finances. Through their evaluations, these national monitoring institutions will play an important role in ensuring that fiscal imbalances are minimised and corrected sufficiently rapidly in line with legal requirements.

Additionally, the earlier and more automatic correction of imbalances should also reduce the risk of the MTO becoming a moving target. Faster progress towards the MTO of a balanced budget in structural terms may have a temporary negative impact on activity and employment, but should improve debt sustainability and reduce the burden of a higher public debt on future generations.